RICHARD RUSSELL'S **DOW THEORY LETTERS, INC.**

P. O. Box 1759, La Jolla, California 92038
Minimum of 26 Letters per year – $150 Annually
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September 21, 1978 | LETTER 739 | Sept. 8, DJIA 907.74; PTI 958; A-D Ratio –15.73
Sept. 15, DJIA 878.55; PTI 947; A-D Ratio –15.84

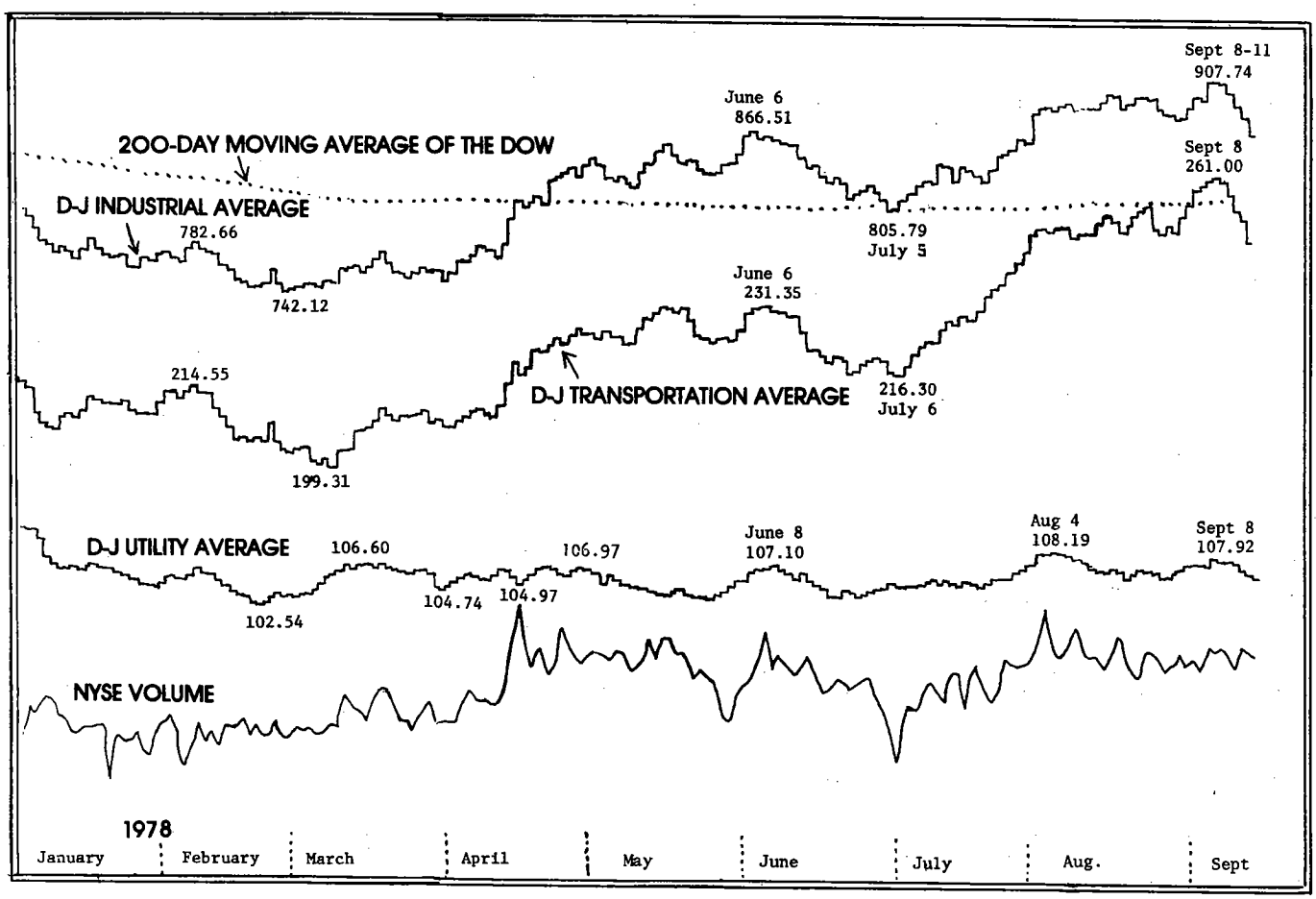
BACK-TO-FRONT: I'm going to present this Letter backwards, because I left Thursday for the San Francisco Investment Conference, and I want to save my stock market comments for the last–to be written after I return on Monday, Sept. 18. I want to start this report with a piece on spending, because there has been a lot of mindless talk recently about how the country is going to come to its senses and cut back on this or that. I don't believe it. For every item the nation cuts back on, there will be two more to take its place. Just watch the Federal budget for 1979 and 1980. That will tell us about spending, and I'll make a prediction that the spending continues to go up, up and away.

THE PICTURE: My friend Larry Williams (he publishes an advisory report) is running for Republican Senator in the state of Montana. Larry did an extensive survey in Montana, and he found that 66% of the people "wanted a substantial tax cut **now**." But adds Larry, "most importantly, 45% wanted the tax cut even if it meant more deficit spending! Even if it meant not having a balanced budget. People here in the Rocky Mountain area are simply fed up with government taking money away from them in the form of taxation. I suspect this feeling is valid throughout the country."

I'm sure it is too. And what the people want, they're undoubtedly going to get. The politicians will continue to give the people "the tax cut candy" they demand right now. But as for cutting the spending, forget it. Spending is where the politicians obtain their power, and they are not about to give their power away. My guess is that we may see a good deal of local, state and government tax cutting–but damn little in the way of spending cuts. And that's another way of saying "deficits and inflation."

In my considered opinion, the only way we are going to see spending cuts in this nation is through the route of collapse and depression. When a man is on a "wild bender," he'll keep on drinking, whooping it up and spending until he gets that call from his accountant telling him that "you're broke." When that happens his credit is cut off and the spending stops. It's the same with politicans and governments. No government I ever heard of whittled itself down in size. Governments have fallen from power, they've been thrown out, they've been voted out, but they've never reduced their power via the less-spending route.

RENDEZ-VOUS WITH DEBT: I've been writing about and talking about the towering US debt structure for many months. In the August issue of World Oil (published by Gulf Publishing of Houston, Texas) there appears an article which I believe has momentous implications. The article was written by Dr. H. A.

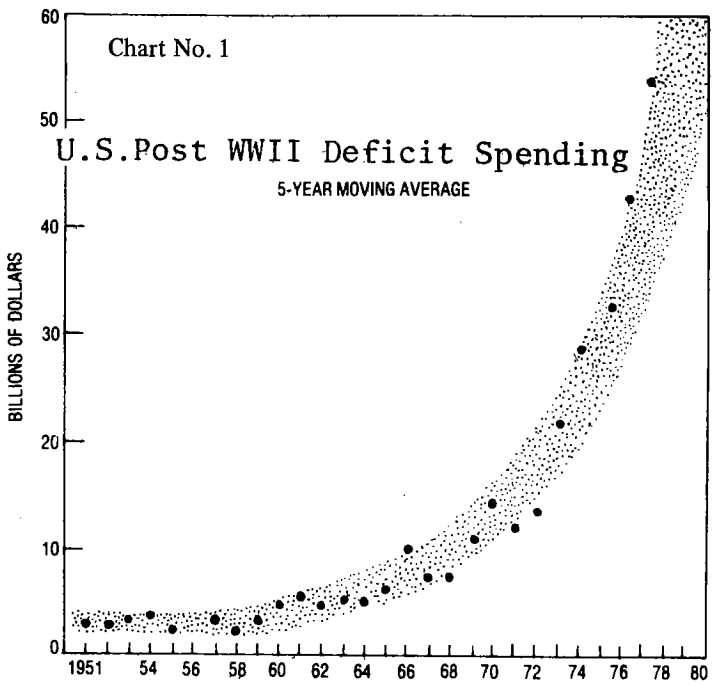


Merklein, Professor of the Graduate School of Management, University of Dallas.

What is so important about Dr. Merklein's article is that he documents the debt problem in charts that anyone can understand–and he presents a definite TIMETABLE for what I have often referred to as "the point of no return." With the permission of World Oil magazine, I am going to present some of the highlights of the article. To my mind, this is one of the most important perspective pieces on the debt picture ever written.

Turn to the chart marked no. 1 (p. 2). The shaded zone of this chart represents a five-year moving average of the annual US deficits since the 1950's. Note that the moving average rose very slowly in the period of 1951 to 1966. After 1966 the moving average of debt moved up on an accelerated basis. At present, the five year average is moving up with explosive force, and it is clear that this kind of rise is unsustainable.

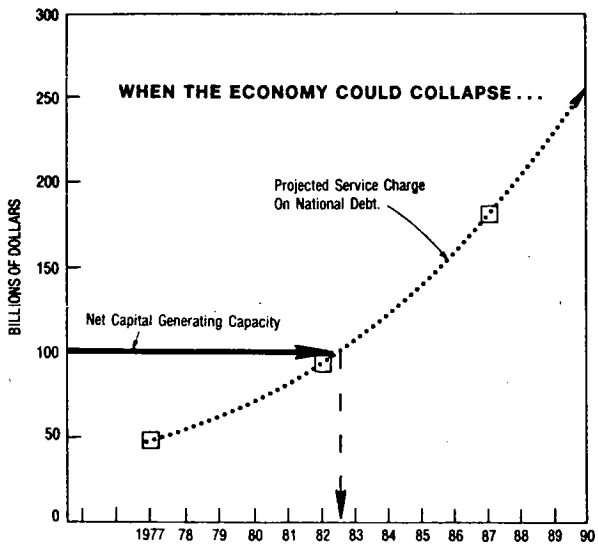
Dr. Merklein wrote an initial article on the subject of US debt in a 1975 issue of World Oil. In that article he presented his targets for forthcoming US deficits. Noted Oil World in its recent August issue, "Sadly we must report that after 32 months and a change of governments in Washington, this latest study shows that the US is continuing hell-bent on a course that can only lead to economic destruction. As one indicator of the accuracy of the projection made 2½ years ago, new data on deficit spending that has since become available ominously fall almost exactly on Dr. Merklein's originally projected deficit curve."



Now turn to the next chart which is labeled "National debt and its cost." This table represents Dr. Merklein's *latest* statistics and projections for the US total national debt. The chart is based on the five year moving average of the debt, *plus* the rising costs for servicing the national debt. Note that during the year 1982 the national debt, for the first time, will go over one trillion dollars. And during 1982, for the first time, the **cost of servicing** the national debt will go (are you ready for this) over 100 billion dollars!

THE NATIONAL DEBT AND ITS COST	National debt	Service charge
(1)	(2)	(3)
1977	685	48
1978	746	55
1979	807	63
1980	877	72
1981	957	82
1982	1,047	94
1983	1,147	108
1984	1,257	123
1985	1,377	140
1986	1,507	160
1987	1,647	181

Dr. Merklein states that the net capital generating capacity of the US is about 100 billion dollars. Based on this figure (which I take to be accurate) the last chart tells the story. Between 1982 and 1983 the service charges (cost) of the national debt will move above $100 billion. At that time the cost of carrying the national debt will eat up the entire capital generating capacity of the US. To put it bluntly, at that time we will not be able to pay the costs of carrying the national debt.



What happens next? The alternatives are few. (1) The US could declare a *moratorium* on all debt and try somehow to reorganize itself the way a *bankrupt* corporation tries to reorganize. (2) The US could declare bankruptcy and attempt to cancel all its debts–in effect, attempt to "start all over again." (3) The incumbent Administration could declare a "state of national emergency," and some sort of military **dictatorship** would be established in an attempt to hold the country together.

(4) The US could attempt *hyper-inflation* as it tries to monetize the debt away. But a state of hyper-inflation would not last long, and the net result would be a collapse in the capital markets, a flight of currency (or exchange controls), a loss of freedom, and then collapse.

(5) The US could attempt to **mobilize gold** with a statement something like this: "The US Government hereby announces that it stands ready to buy or sell gold at $1,000 an ounce. All

creditors may turn in their dollars for gold, and the US will oblige." At such a high price for gold, it is probable that there would be few creditors willing to exchange dollars for gold. Assuming the US *also* went on a severe austerity program, such a re-valuing of gold could effectively "sterilize" tens of billions of dollars of US debt for years to come. Overnight (in the face of a huge official price rise for gold) the US reserves-to-debt ratio would collapse, thus giving the US economy a new lease on life. Of course, such a revaluation of gold would also have to be accompanied by a strong anti-inflation program. Since pressure would also be taken off the debt markets, interest rates would cave in overnight.

Question: How could a giant rise in the price of gold ever occur in a country where the official policy is to downgrade gold and, if possible, eliminate it from the sytem?

Answer: Nations, like men, either come to their senses or they are destroyed. There is no way that I know of to sustain the free enterprise system other than mobilizing gold. When the incumbent Administration is against the wall, they will do what they have to do to perpetuate the system (unless they are willing to jettison the system entirely).

At any rate, to my mind, the timetable is clear enough. The nation has little more than four years (to 1982) to make dramatic moves towards containing the already exploding debt and the accompanying rocketing costs of servicing the debt. But I believe that we have already gone past the point of no return. Any significant cutback in Government spending at this point (with the nation so extended on credit) would undoubtedly bring about depression. And if we continue on the path we are on, we will meet with the stone wall of insolvency around 1982-83.

In outlining the five possibilities above, it is clear that the first three would entail a loss of a large amount of assets (even though the assets are now heavily mortgaged) and probably a substantial further loss of liberty. Example 4 would entail an almost total loss of liberty. Only example 5 would allow the free enterprise system to continue functioning much as it does today. But example 5 would entail a complete reversal of the US Government's pig-headed stance against gold. It would mean that the US would again place gold at the center of its monetary system. It would also mean that the US would again move to a gold-convertible currency.

The US is now 200 years old. It has, at this point, completely broken away from any sane system of monetary control. The "discipline" of Washington or the Fed has not worked, because men are weak and men are greedy. The discipline of gold does work, because gold cannot be manufactured or mined by man's edict (although for centuries alchemists tried to "make" gold). If gold is not given its due, the free enterprise system, as we know it, will topple. The US must make its choice. It is pride and "autonomy" on one side–and gold and dollar convertibility on the other. We've got about four years to go, and the markets will start **discounting** this whole picture rather early.

Question: If we have to mobilize our gold to ultimately save the free enterprise in the US, what happens if the Government continues to auction off its gold?

Answer: The only saving grace in this disastrous policy is that so far the US has not auctioned large amounts of gold. The US still has about 275 million ounces of gold, and each gold auction is only 300,000 ounces, although they will be increased to 750,000 ounces in November. But in my opinion, this policy of psychological war against gold through the auctions is tantamount to fiscal insanity. If the gold auction amounts are increased even further, I would say that the situation would look considerably blacker.

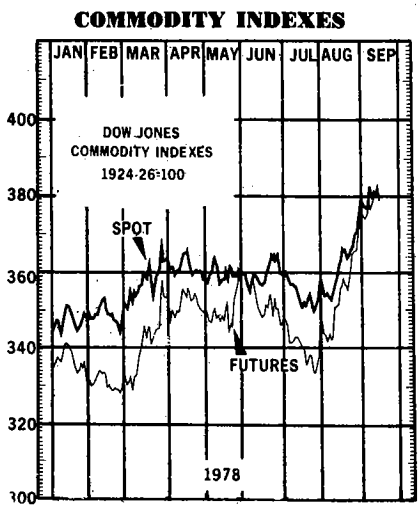
Remember this, the course of history can be traced via the nations that accumulated or lost gold. ***Where gold goes, the power goes***. We see it in the rise and fall of Rome, Holland, France, Spain, England, and every once-powerful nation or empire in history (including the US which held most of the Free World's gold in 1945).

I don't care how gold leaves a country, whether by force, by intent, by being called by its creditors or by auction. The FACT that gold is leaving a nation is a significant signal that the nation is losing its power. The very existence of US gold auctions is ominous. A strong US would be accumulating gold, not auctioning it off. Personally, I believe that the US auctions and the increase in the size of the auctions were part of some kind of agreement between the US and its creditors. Our creditors WANT our gold as cheaply as possible, and auctions are one way to get it at a low price (aided, ironically, by a US Administration that continues to "talk down" the value of gold!).

I'll add one more thought to this section. It may be PRIDE that brings down a nation. Only a few decades ago the US was the undisputed richest nation in the world, holder of most of the world's gold, leader in world production, leader in world technology. In the past few years the US has suffered through its pride. It has failed to win a costly war in VietNam, it has seen Europe become the leading holder of gold, it has seen its technological lead dwindle away, it has seen its productive capabilities challenged, it has watched its currency being debased.

Now the US stoutly insists that "gold must go." But the markets are saying that gold will win and it is the dollar that may go. Pride goeth before a fall. Pride also blinds men. Let's hope Washington and the nation are able to give up their pride–and soon.

RUN-DOWN: Commodities: My commodity charts suggest more across-the-board strength now than at any other time since May. The meats have turned strong with cattle and hogs nearing their May peaks. The Soybean complex has pushed to a three-month high. Oats have turned bullish. Corn has probably bottomed. Wheat and sugar have turned up and look higher. All this will mean higher prices at the dinner table and more inflationary pressures during 1979.



Furthermore, rises in food prices hit the consumers (should we call them voters) where it hurts the most–Jimmy Carter, are you listening? For tracking commodities, I use the excellent daily chart from SMR, PO Box 14096, Denver, Colo. 80214. But the accompanying chart from the Wall Street Journal tells the story. The D-J Commodity indices are not the best commodity indices around, but they will do. The story is–prices heading up and more inflation.

Precious Metals: Gold is now definitely taking the lead with silver and platinum lagging. Nevertheless, silver and platinum have not yet turned bearish, and I doubt if they will as long as gold remains in its bullish trend.

Bonds, Interest Rates: The mystery deepens here. The long-term bonds are acting "as if" they have bottomed, but the short rates are about at the high of the year with T-bills currently yielding near 7.8% (and no state taxes are paid on T-bills). A few observations can be made about past interest rate peaks. (1) Interest rates usually do not peak until the economy is in recession. At least that has been the experience since the 1958 recession. (2) Interest rates usually do not peak until short rates have climbed ABOVE long rates. This has not yet occurred. (3) Interest rates usually don't peak until there is a pronounced decline in the growth rate of M-1. This has not yet occurred.

Currencies: The British pound is beginning to look toppy against the dollar, but so far no real downward pressure on the pound. The Deutschemark has backed off its early August .5180 high. The yen has also come down from its August high and both the mark and the yen appear to have topped out against the dollar, at least on a temporary basis. The Swiss franc remains in a class by itself in regard to strength, although the franc too is below its early August high of .6370. In all, it's clear that the dollar has found some sort of temporary bottom and it is now firming against the major hard currencies. In my opinion, the dollar was technically ready to rally against other currencies following its disastrous 1977-78 collapse. It will be necessary to keep short-term interest rates fairly high to preserve any kind of strength in the dollar. This is particularly true in the face of the grim deficit and balance-of-payments figures being turned out by the US.

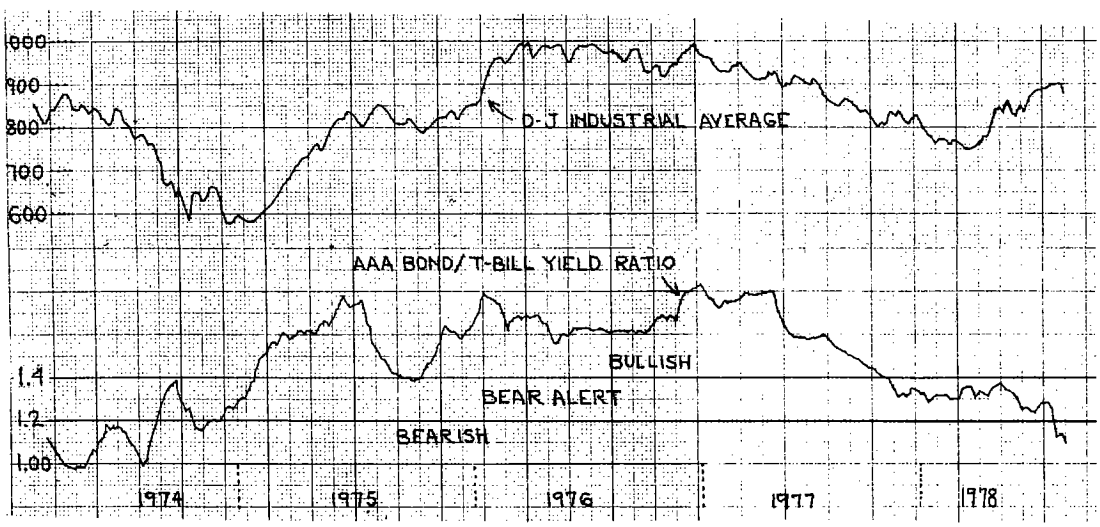
RATIO: One of the gauges I use to measure "money pressure" is simply the **ratio** of AAA bond yields to 91-day T-bill yields. Normally, AAA bond yields will be substantially above T-bill yields. But when the pressure is on in the money markets, the bill yields rise, and when the pressure is intense the bill yields can actually shoot over the bond yields.

This weekly chart tracks the Dow and the AAA bond/bill yield ratio from 1974 to the present. As you can see, the ratio has now dropped into the bearish ("high pressure") area, and at 110 the bill yields (7.80) are moving to within a point of Moody's AAA bond yields (8.65). If and when the bill yields go OVER the bond yields, you'll know that the money markets are in the big vice. They're getting close now, very close. Historically, anytime this ratio drops below 1.20 it is bearish for equities. But since we're buyers of T-bills, it's great for us.

BACK: We got back from the big ICI San Francisco conference, and if I learned only this one thing, it was worth it in spades. Here's what I learned—if you want to know if a man is a politician, ask him about gold. If he pussyfoots, he's a politician. I publicly questioned ex-Treasury Secretary Simon about gold after his "brave" speech. Mr. Simon had stated that "he wasn't against gold," but that he did not want it in the US monetary system. I retorted "If you're not ***for*** gold, you're against it. It's not enough to say that you're not against gold. That's like saying that you're not against health." Mr. Simon parried by noting that Germany, which has little gold, is getting along fine and has a good balance of payments. Why couldn't the US be like Germany? I said that Germany is now re-flating and that Germany's money supply is booming. I added that the mark was not acting all that well, and that if Germany continued this way, the mark would soon slide with the dollar. Simon admitted that that was true. "Well," I added, "then I cannot for the life of me understand why you prefer to push politicians to discipline themselves rather than using the discipline of gold."

It was noted by all that ex-Treasury Secretary Simon simply changed the subject. As far as I am concerned, his new best selling book, "A Time For Truth" is fun, games, complaints and empty wishes. Simon is a politician. He's still trying to get other politicians to discipline themselves on the spending front. He might as well try to get water to run up hill. And that's what I learned about gold, politicians and truth in San Francisco. I'll tell you in all honesty, I'm still annoyed or angry about it. I never realized what rot and BS the anti-gold politicans spew forth. They don't really want monetary discipline. They just like putting up a "good front."

The Hyatt Regency Hotel (where the conference was held) is a spectacular building, and prices are as high as the Towers (our room was $100 a day). Food is good, service fast (when the hotel computer is working), and I got the feeling of being in a city within a city. Sometimes I think it's worth living in San Francisco or Vancouver just to be able to eat their poached salmon (which I could live on). Down here in San Diego, we have the values and the bargains and the weather—but they don't know from fishes in this town. Give a San Diego restaurant a fish, and they'll either fry it or boil it in butter or trade it in for a hamburger. But some day, civilization will come to the South!

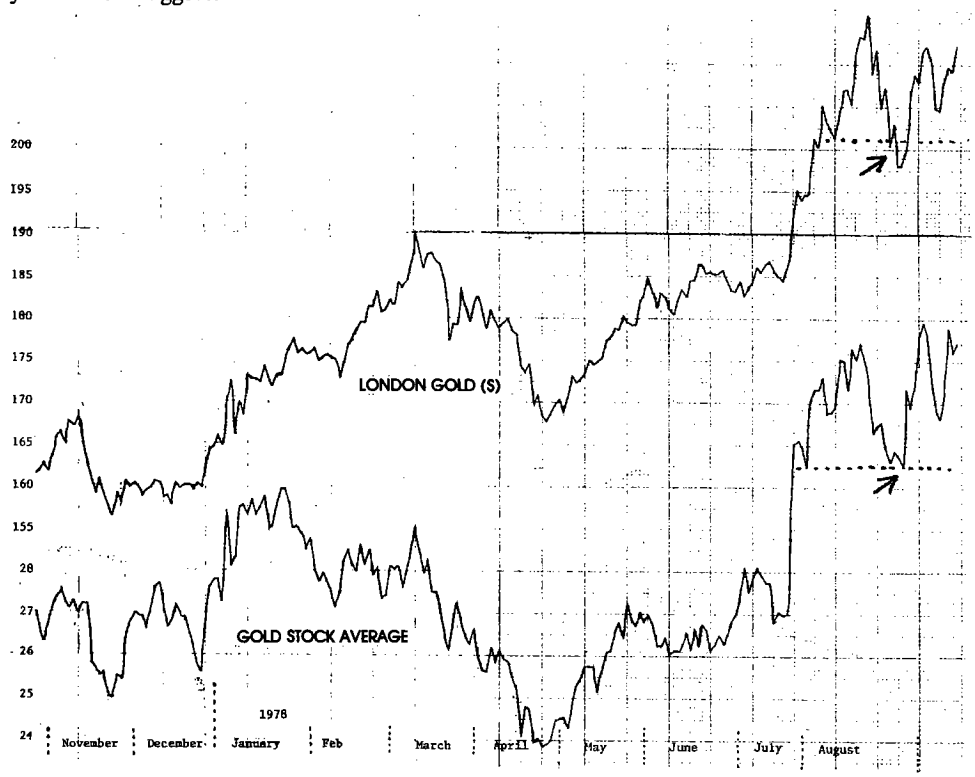


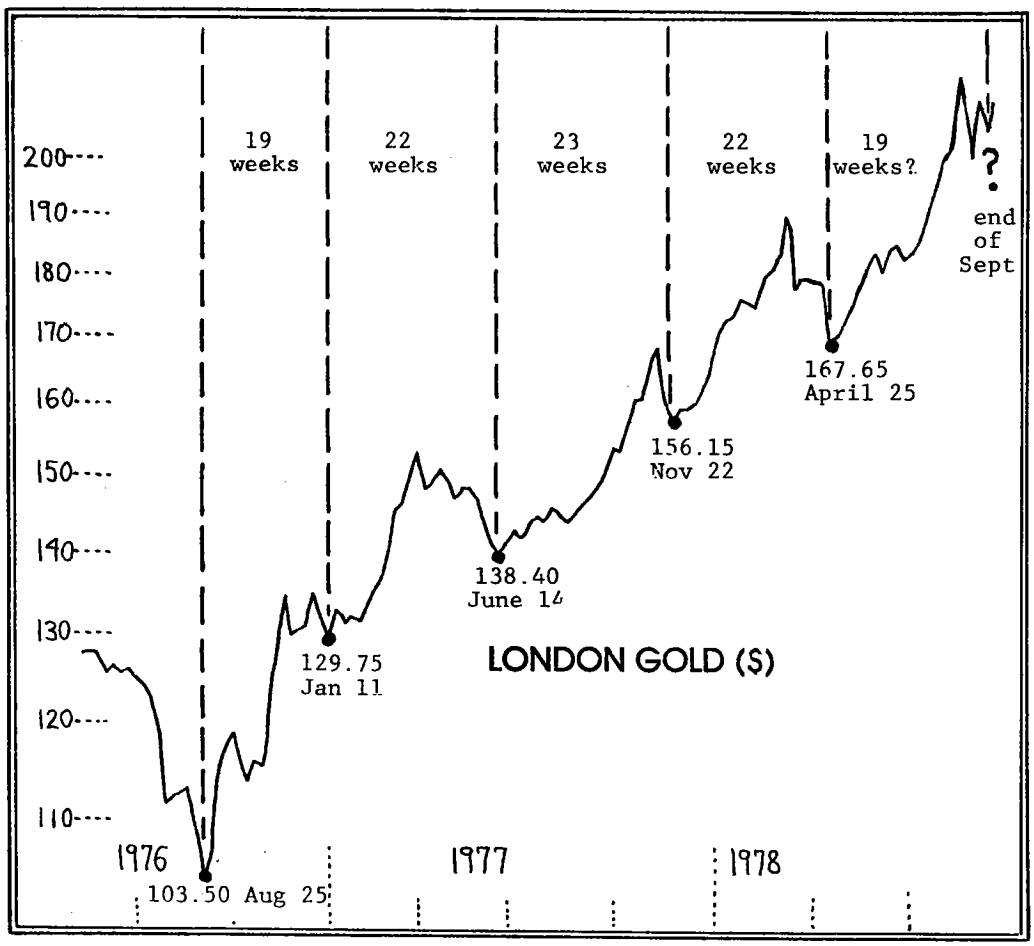
I spoke to Jim Blanchard last week and he tells me that the NCMR New Orleans Conference ticket sales (so far) are double that of last year at this time. I urge any and all of my subscribers who have the inclination to sign up or call for information at (504) 865-9919. The line-up of speakers is going to be extraordinary, and their new brochure tells it all. I really mean it when I say that I wouldn't miss the New Orleans Conference for anything (and I'll be speaking there—Nov. 2-5).

GOLD: Gold has been holding stubbornly above the 200 level, and that's bullish. Strangely (or maybe they know something I don't), almost everybody is predicting a gold correction "back to 181" or "back to 190" somewhere downhill. I think gold looks like it means to hold 200. Furthermore, my Canadian buddy Ian McAvity came up with a gold cycle which suggests that gold hits an intermediate bottom every 19 to 22 weeks. I divided my own ratio-scaled gold chart and I believe that Ian's "got it right." The chart (bottom of page) is self-explanatory, and it appears that the cycles are roughly 21 weeks (a Fibonacci 21 always intrigues me).

If the chart is correct, we're right about at the bottom of the cycle now, and the pressure for the next 10 to 15 weeks should be up. Note also that the last correction (down from the 215.90 high of mid-August) has been the mildest in many a month. When an item doesn't want to go down, it's usually ready to go higher, and that would be my rough prognosis for gold.

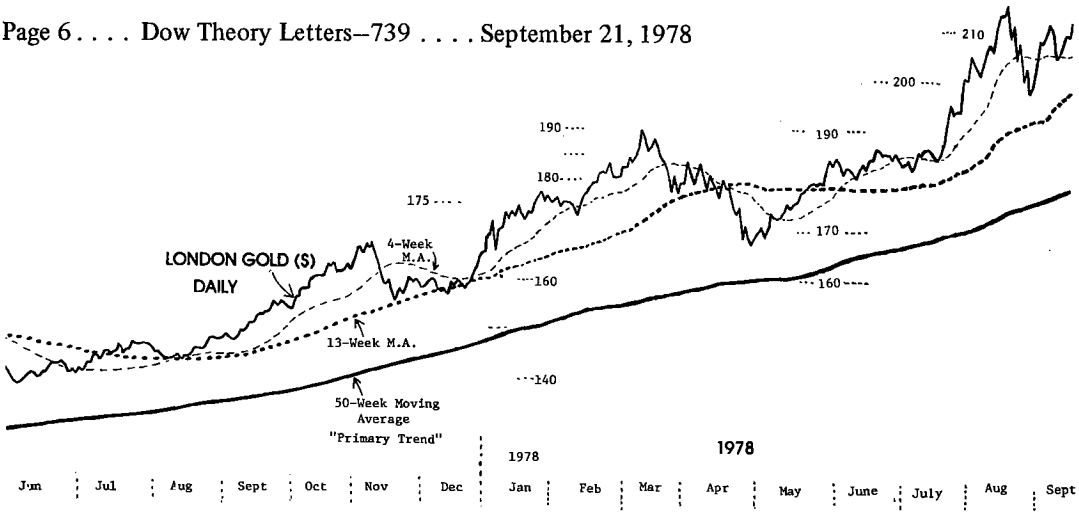
I'm also including my daily gold and gold stock average (GSA) chart. Here the operative word is **confirmation**. These two items have an excellent record of confirming each other, and when they do not, we can expect a reversal. Note that in late-August, bullion broke below its early August low while the GSA refused to confirm. This was bullish, and it pointed to higher prices all around. And that's what we got. Currently, it appears to me that gold will try to move above its 215.90 high fix for the year. And it also looks as if the stock average (which is only a fraction from its high) will try to do the same.





The moving averages for gold (p. 6) are all rising, with the 4-week MA at 206, the 13-week MA at 199 and the 50-week now at 180. I consider the 50-week MA to represent the primary trend of gold, and this long-term MA is now advancing at the rate of 1 to 2 points per week.

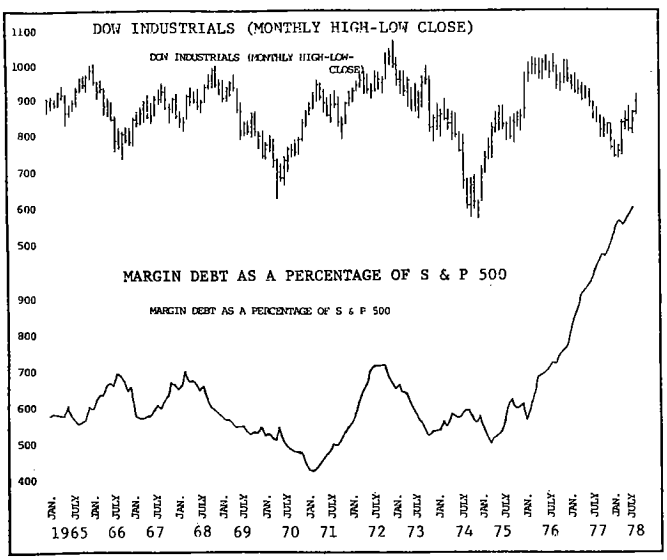
I've been asked about the latest item in the US's "war on gold," the boosting of the monthly auction to 750,000 ounces. As far as I'm concerned, the US gold auctions represent nothing more than THE US LOSING GOLD. And that's a bearish omen for the US (based on a study of gold flows throughout history). As gold goes, so goes a nation's power. But actually, the 750,000 ounces are a small amount when you consider that the US gold futures markets trade about 50 million ounces a month! Yet, from another standpoint those 750,000 ounces represent roughly 9 million ounces a year that the US and its citizens are losing. At that rate, in 30 years the US would be out of gold. Never has the US Treasury and a US Administration been so misguided on a single subject.

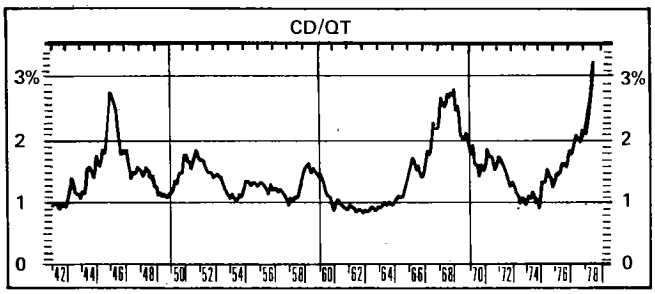


MARKET: BOILING SPECULATION: By any reckoning, the 1978 market has been one of the most speculative in history. To that extent, one can liken it to 1929. In the last year of the 1929 bull market, thousands of "little fellows" bought stocks at 10% down (margin). Thus, when the great bull collapsed the margin calls wiped out hoards of buyers and the resultant carnage tore the market apart.

Today, we have the counterpart of the 10% down buyer in the option field. For a few hundred dollars (in options) a man can buy a call on stock worth thousands. And the fact is that millions of options have been traded over the past few months and the speculative action in this market has been fierce.

I was asked over and over at the ICI Conference about gold futures. My answer is always the same. I want my subscribers to HOLD gold. The futures are a trading device or a hedging device. You don't invest with futures, you don't ride the primary trend with futures, you trade 'em. I don't know anyone who bought gold futures six months ago and still has them. And my bet is that 75% of the people who dabble in gold futures (regardless of the trend of gold) will at best break even. That's not what I want my subscribers to do. I want you to buy the coins or the bullion and SIT ON THEM! Any Administration and Treasury department that tries to beat real money with inflating paper has to lose. When they lose, they'll lose to gold. If you really think you can beat gold with depreciating dollars, you might as well go out and try to sell corned beef hash for roast beef. It can't be done.





Examine these two charts at the bottom left. The first was put out by Ned Davis of J. C. Bradford & Co. It shows NYSE margins adjusted by dividing the margin by the S&P 500. Margin is now higher than at any other time in history. For whatever reason, there are one hell of a lot of people out there sitting with stocks that they do not totally own. When a man buys something on credit, he either wants it awfully badly or he thinks it's going to get away from him on the upside. Either reason is tenuous, especially when you realize what it costs to go on margin today (in terms of interest!).

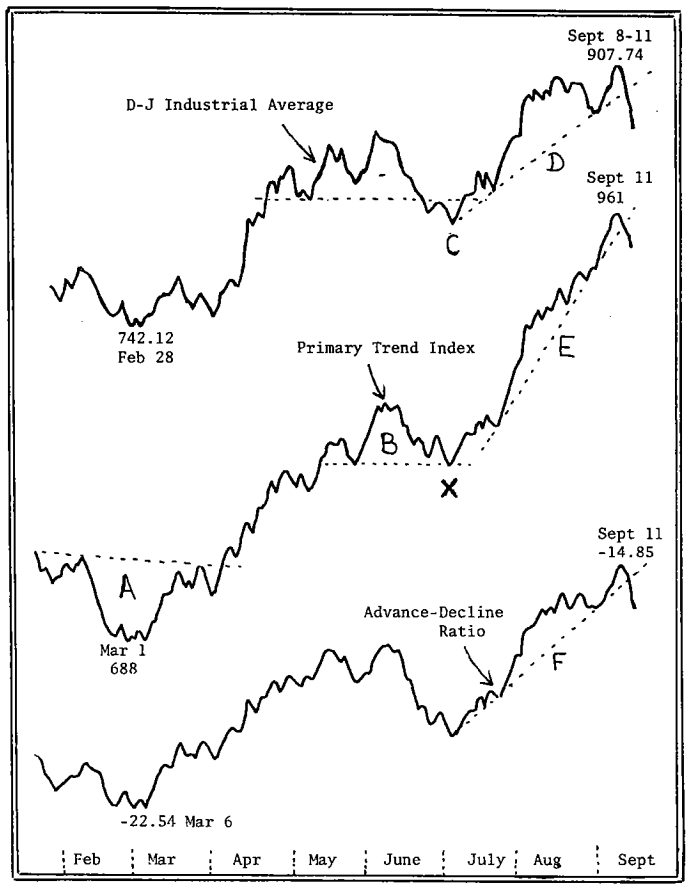
The second chart, published by *Indicator Digest* of Palisades Park, NJ, is what Indicator calls its speculative index or the **ratio** of the "cats and dogs" (CD) to the quality stocks (QT). This chart covers the period of 1942 to the present or over three decades. Right now the ratio is at its highest point on record, so here too we must say that the speculation has been super-intense. It's been one frothy market, in case you didn't notice. And bubbles often burst.

* * * * *

The 907.74 Dow high of September 8 and 11 could represent a most important top–for a number of reasons. First, the Fibonacci ratio of 61.8 applies. If you remember, at the February Dow of 742.12 I applied the Fibonacci ratio (see Letter 723) as follows. From the 1974 Dow low of 577.60 to the 1976 high of 1014.79 was 427 points. And 61.8% (the Fibonacci ratio) of that rise in 270 points. If we subtract 270 from 1014.79 we get 744. The Dow halted its decline from the 1976 top at 742.12, **within 2 points** of the Fibonacci number.

Now let's move to the present. From the 1976 peak of 1014.79 to the recent February, 1978 low of 742.12 is 272.67 points. If we take 61.8% of 272.67 we get 168.51. If we add 168.51 to 742.12 (the low) we get 910.63. That's 3 points from the September 11 Dow peak of **907.74**. So 907.74 could be important.

I've mentioned many times the importance of the *halfway* level of major advances and declines. The halfway level of the 1976 to 1978 decline (1015.79 to 742.12) is 878.45. That level seems to be a critical fulcrum, and we have seen the Dow teeter above or below 878.45 many times. On September 15 the Dow closed at 878.55 (!), just .10 above the halfway level. On Monday the



Dow dropped 8 points to the 870 level. If the Dow cannot hold 878, I would again think that important weakness had overtaken the market.

I am including a chart of the Dow (daily) and two indicators that I follow closely. The first is my own Primary Trend Index (PTI) which is an amalgam of 8 indices. I am going to be paying a good deal more attention to the PTI in forthcoming Letters.

Note that the PTI formed a head-and-shoulders bottom during February and March (A on chart). When the PTI broke out above the resistance (dotted line) the advance was on. During May and June the PTI appeared to be forming a H&S top (B on chart). The Dow (at C) broke down but the PTI refused to confirm (X on chart). That nonconfirmation led to the latest rise to Dow 907.74.

Over the last week all of the indicators on this chart broke trendlines (D,E,F on chart). A decline is now clearly underway–but how important is that decline fated to be?

My own guess is that the market has topped out in a most important way, but I want to watch the PTI and the A-D Ratio very carefully. The PTI almost always forms some kind of a top formation at major peaks, and so far the PTI has just rolled over and dropped. I'll be able to tell more in the next few weeks. On the other hand, the A-D ratio is now not far from its May and June peaks, and it has been coming down hard.

Most of my other indicators have been "overbought" since May, so that in actuality, I have been amazed that the advance has carried as far as it has. Often, the most **persistently** bullish (or bearish) indicator is the one to watch. Since February, by all odds the most stubbornly bullish indicator has been the cummulative most-active stock index on the NYSE. This is one place, then, that I will be watching closely. If the plurality of the daily most actives begins a steady decline, then I would say that this market is heading importantly lower. Since August 1 (34 trading days) there have only been 5 days when the most-actives plurality was not plus. When the speculation on the NYSE turns to fear, the most actives should lead the way down as persistently as they have led the way up.

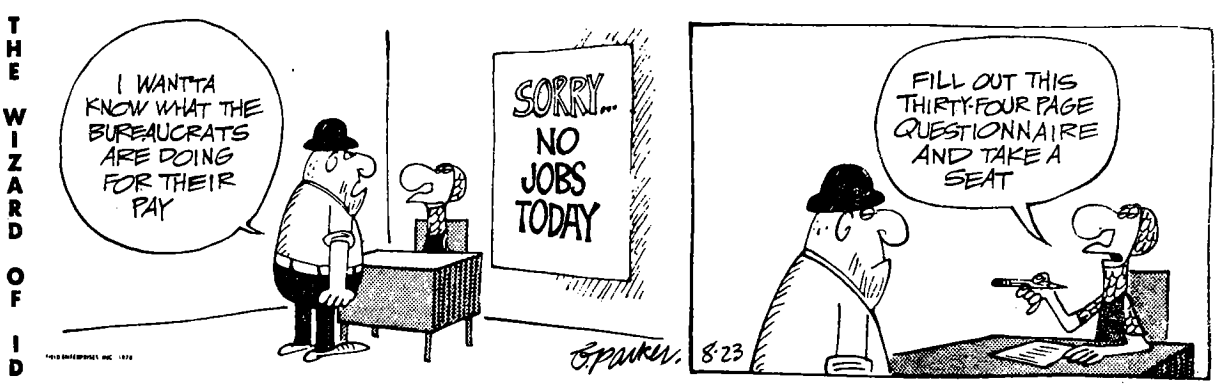
WHAT TO DO: Aside from our positions in T-bills and gold, this is a time when put options look interesting. The GM 50's coming due in April sell for under a dollar, and I think they could be a profitable play. The same with the Avon 50's due in April, which sell for about $1.50. We need a lot more puts on the various markets, and from what I gather they will be coming.

Meanwhile, I personally am staying away from bonds. But with the interest rate squeeze now on, it is interesting to speculate on where the final bond lows will be. My guess is that interest rates are going higher than most people think–a good deal higher. So far, businessmen have factored interest rates into their plans–and consumers have done the same. To be anti-inflationary, interest rates have to go so high that they hurt. We're not there yet, not by a long shot!

Note: with the Israeli-Egyptian peace conference seemingly successful, one might have expected gold to sag. It acted as if nothing had happened, which is a very strong omen for the yellow metal. Gold is more interested in US deficits than peace parlays–or so it seems.

Second note: Canada is coming out with half and full ounce gold coins, and Australia is probably going to be next. With nation after nation offering gold coins, it seems increasingly remote that the US will ever confiscate gold again. How would we look confiscating gold when all the other free nations are minting gold coins? Or doesn't Washington care how we look at this stage of the game!

I JUST SPENT 5 hours applying for permission (Zoning Board, Coastal Commission) to build a little addition atop my garage, so I don't know if this cartoon is funny or just plain truthful. Boy, could I use less government!


THE WIZARD OF ID
I WANT'TA KNOW WHAT THE BUREAUCRATS ARE DOING FOR THEIR PAY
SORRY... NO JOBS TODAY
Parker
FILL OUT THIS THIRTY-FOUR PAGE QUESTIONNAIRE AND TAKE A SEAT
8-23

NEXT LETTER WILL BE MAILED: October 4.